SUPREME COURT, U. S.

No. 127

In the Supreme Court of the United States

OCTOBER TERM, 1967

READING COMPANY, PETITIONER

v.

FRANCIS SHUNK BROWN, 3RD, TRUSTEE OF THE ESTATE OF I. J. KNIGHT REALTY CORP., BANKRUPT, AND UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES

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INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute involved	2
Statement	2
Summary of argument	4
Argument:	
Introduction	6
I. The claims of petitioner and others damaged through the spread of the fire are not entitled to the priority accorded costs and expenses of administration of an arrangement under Chapter XI of the Bankruptcy Act in an ensuing bankruptcy	10
A. The word "necessary" in Sections 62a(1) and 64a(1) should be applied in a manner that implements the congressional purpose of limiting claims given priority in order to promote the relief of general unsecured creditors and of creditors having subordinate priorities	10
B. The policies that allow a first priority to certain operating expenses of Chapter XI arrangements do not justify giving the same treatment to petitioner's tort claims	16

286-711—68——1

Argument—Continued
Introduction—Continued
The claims of petitioner etc.—Continued
C. The grant of a first priority to tort claims would conflict with the general treatment of such claims in bankruptcy ..... Page 20
D. The pertinent equitable considerations require that petitioner be denied a first priority 26
II. The rules of "equity" receiverships do not entitle petitioner to preference over the claims of the United States 30
A. The rules applied to equity, Chapter X, and railroad reorganizations should not be applied in ordinary bankruptcies and arrangements 30
B. Even the rules of equity receiverships should not entitle petitioner to priority over the tax claim of the United States 33
Conclusion 35
Appendix 37

CITATIONS

Cases:

American A. & B. Coal Corp. v. *Leonardo Arrivabene S.A.*, 280 F. 2d 119 ..... 8, 25
Baldwin, Matter of, 291 U.S. 610 22
Capital Service, In re, 136 F. Supp. 430 14
Chicago Express, Inc., In re, 332 F. 2d 276 31
Connecticut Motor Lines, Inc., In re, 336 F. 2d 96 ..... 13, 19, 32
Denton & Anderson Co. v. *Induction Heating Corp.*, 178 F. 2d 841 ..... 15, 19

Cases—Continued Page

Dial v. *Chatman*, 70 F. 2d 21 11
Favelo v. *Reeves*, 227 U.S. 625 19
Goldblatt v. *Hempstead*, 269 U.S. 590 34
Groggin v. *California Labor Div.*, 336 U.S. 118 11
Irving Electrical Supply Co., In re, 41 F. Supp. 16 14
Kuehner v. *Irving Trust Co.*, 299 U.S. 445 34
Michigan Motor Specialties Co., In re, 288 Fed. 377 25
Mt. Washington S. S. Co., In re, 43 F. Supp. 176 14
Nicholas v. *United States*, 384 U.S. 678 ..... 14, 15, 19
Piedmont Corp. v. *Gainesville & N. W. R. Co.*, 30 F. 2d 525 33
Progress Lektro Shave Corp., In re, 35 F. Supp. 915 ..... 24, 25
Randolph v. *Scruggs*, 190 U.S. 533 13
Schall v. *Camors*, 251 U.S. 239 ..... 20, 26
Securities & Exchange Commission v. *U.S. Realty Co.*, 310 U.S. 434 ..... 15, 27
Swarts v. *Hammer*, 194 U.S. 441 15
United Button Co., Matter of, 140 Fed. 495, affirmed, 149 Fed. 48 22
United States v. *Anderson*, 334 F. 2d 111 ..... 31, 34
Valdes v. *Feliciano*, 267 F. 2d 91 19
Vass. v. *Conron Bros.*, 59 F. 2d 969 24
White v. *Murtha*, 343 F. 2d 831 14
Williams v. *U.S. Fidelity Co.*, 236 U.S. 549 27
Wright v. *Union Central Ins. Co.*, 304 U.S. 502 34

United States Constitution and statutes:

Constitution of the United States, Fifth Amendment 34
Act of 1841, repealed by Act of March 3, 1843, 5 Stat. 614 12

United States Constitution and statutes—Con.
Page
Act of 1867, repealed by Act of June 7, 1878, 20 Stat. 99 12
Act of June 7, 1934, 48 Stat. 911 20
Act of July 5, 1966, 80 Stat. 270, Secs. 2 and 3 ..... 3, 11
Bankruptcy Act, c. 541, 30 Stat. 544:
Sec. 17 (11 U.S.C., Sec. 35) 3
Sec. 57d (11 U.S.C., Sec. 93d) 5, 21, 22, 23, 24, 26
Sec. 62a (11 U.S.C., Sec. 102a) 2, 4, 8, 9, 26, 37
Sec. 63a (11 U.S.C., Sec. 103a) 2, 4, 5, 17, 19, 20, 22, 23, 24, 25, 26, 27, 30, 37
Sec. 64a (11 U.S.C., Sec. 104a) 2, 3, 4, 7, 8, 9, 10, 12, 26, 29, 30, 31, 37
Sec. 77 (11 U.S.C., Sec. 205) 6, 9, 30, 32, 33
Sec. 77n (11 U.S.C., Sec. 205n) 32
Sec. 199 (11 U.S.C., Sec. 599) 9, 33
Sec. 271 (11 U.S.C. 671) 33
Sec. 302 (11 U.S.C., Sec. 702) 8, 10
Sec. 337 (11 U.S.C., Sec. 737) 29, 30, 33
Sec. 378(2) (11 U.S.C., Sec. 778(2)) 19
Sec. 397 (11 U.S.C., Sec. 797) 29, 33
40 Purdon's Pennsylvania Statutes Annotated (1966 Supp.) Sec. 636 29
Miscellaneous:
3 *Collier on Bankruptcy*:
par. 57.15 22
par. 62.02 31
par. 62.14[3] 14
par. 63.25 22
par. 64.01 11
par. 64.402 10
par. 64.501 11
3 *Collier on Bankruptcy* (Fourteenth ed. 1964), par. 6325 25

Miscellaneous—Continued

	Page
6 *Collier on Bankruptcy:*	
par. 1.06	32
par. 3.17	32
6A *Collier, supra,* par. 9.10, 9.17	34
Analysis of H.R. 12889, 74th Cong., 2d Sess	11
H. Rep. No. 2320, 82d Cong., 2d Sess	15
H. Rep. No. 687, 89th Cong., 1st Sess	11
S. Doc. No. 156, 55th Cong., 2d Sess	12
S. Rep. No. 1954, 87th Cong., 2d Sess	15
Underhay, Tort Claims in Receivership and Reorganization, 22 Iowa L. Rev. 60 (1936)	11, 33

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OPINIONS BELOW

The opinion of the district court (R. 36–49) is reported at 242 F. Supp. 337. The majority (R. 50–56) and dissenting opinions (R. 56–61) of the court of appeals are reported at 370 F. 2d 624.

JURISDICTION

The judgment of the court of appeals was entered on January 6, 1967 (R. 62). A petition for rehearing was denied on February 13, 1967 (R. 3). The petition for a writ of certiorari was filed on May 4, 1967, and was granted on October 16, 1967 (R. 63). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether tort claims resulting from a fire caused by the negligence of the receiver having control of the debtor's estate during an arrangement under Chapter XI of the Bankruptcy Act are entitled in an ensuing bankruptcy to the priority in payment that Section 64a(1) of the Act gives the "unpaid costs and expenses of administration" of the arrangement.

STATUTE INVOLVED

The relevant statutory provisions, Sections 62a(1), 63a(7), and 64a of the Bankruptcy Act are set out in the Appendix, *infra*.

STATEMENT

On November 16, 1962, I. J. Knight Realty Corporation petitioned for an arrangement under Chapter XI of the Bankruptcy Act. On that day the district court appointed a receiver and authorized him to operate the debtor's business of leasing space in the Fretz Building in Philadelphia, the debtor's principal asset, and to operate the building for the benefit of its tenants (R. 36, 51).

On January 1, 1963, the Fretz Building was completely destroyed by a fire of unusual intensity that spread to adjoining premises, thereby damaging the property of petitioner and others (R. 36–37, 51). On April 3, 1963, petitioner filed in the arrangement a claim of approximately $560,000 for its fire losses, asserting that they were "administrative expenses due to the negligence of the Receiver" in operating the debtor's business. Thereafter, 146 others filed claims

on the same theory. The total of all such claims, including petitioner's, exceeds $3,500,000.[1] On May 14, 1963, the debtor was voluntarily adjudicated a bankrupt and a trustee in bankruptcy was elected. (R. 37, 51; see also R. 4–16.)

Other claims against the estate—which arose before the filing of the Chapter XI petition—total about $625,000, including federal tax claims of $245,000.[2] Depending upon the outcome of pending litigation against the debtor's fire insurers, the estate's assets will be between $630,000 and $845,000. (R. 38, 51 n. 2.)

The trustee in bankruptcy moved to expunge petitioner's claim on the ground that it was not "one of the actual and necessary costs and expenses incurred * * * in the administration of estates." (R. 17, 37, 51.) Solely for the purpose of the motion to expunge, the trustee conceded that the receiver's negligence—imputed from the acts of a plumber he had hired—caused the fire and its spread (R. 18, 37). The referee, agreeing with the trustee that the petitioner's claim was neither an administrative expense nor a general provable claim (R. 23–34), granted the motion (R.

[1] The instant case is a test case for all the claims (R. 19–20, 22, 24, 37–38).

[2] Most of the Government's tax claim will not be affected by Sections 2 and 3 of the Act of July 5, 1966, P. L. 89-496, 80 Stat. 270, which amended Sections 17 and 64a(4) to provide for the discharge, and exclude from the fourth priority, such taxes as became legally due and owing more than three years preceding the adjudication in bankruptcy.

Of the total tax claims here asserted, up to $16,523.69 may be secured by liens on real property and therefore would be superior to administrative expenses.

286-711—68——2

34). The district court affirmed (R. 36–49). The Court of Appeals for the Third Circuit, by a four-to-three decision on rehearing *en banc*,[3] affirmed the district court's holding that the tort claim was not a necessary cost of administering the estate and therefore was not entitled to a first priority pursuant to Section 64a(1) of the Bankruptcy Act, 11 U.S.C. 104a(1) (R. 50–61).[4]

SUMMARY OF ARGUMENT

I

The Bankruptcy Act requires that the definition of administrative expenses of Section 62a and the priorities established in Section 64a, and not the rules developed in non-statutory equity receiverships, govern the determination of whether the tort claims of petitioner are entitled to the priority status that Section 64a(1) accords the administrative expenses of an arrangement under Chapter XI in an ensuing bankruptcy. Those sections make clear that administrative expenses include only those which were "necessary" to the preservation of the debtor's estate. In cases such as the arrangement here, where the bankruptcy court has allowed the debtor's business to continue to operate, such expenses are limited to those essential to such operation—for example, amounts due suppliers and workmen who, during the arrangement, sell goods

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[3] The appeal was first argued to a three-judge panel, but, before decision, the court *sua sponte* ordered a rehearing before the full court.

[4] In the court of appeals, the petitioner agreed that its claim was not provable as a general claim under Section 63a(7) of the Bankruptcy Act, 11 U.S.C. 103a(7) (R. 52, n. 3).

and provide services to the business. The reason for such a priority is to allow the business to continue, and thus seek rehabilitation.

Petitioner and others who sufferred damages as a result of the Fretz Building fire acted no differently than they would have in the absence of the arrangement. Nor did the continuation of the arrangement in any way increase their risk of loss. Thus, although there might be circumstances in which tort claims arising during an arrangement might be entitled to first priority—as when a business invitee is injured—there is nothing in this case that requires petitioner to have such a priority in order to encourage the rehabilitation of business through Chapter XI arrangements.

Nothing in the Bankruptcy Act would have barred petitioner from filing a claim as a general unsecured creditor, if it had complied with the requirement of Section 63a(7) that it file suit before bankruptcy. The availability of the general fund to satisfy claims arising from torts commited during the arrangement adequately protects the public interest in encouraging careful conduct of the business.

Moreover, to grant petitioner a first priority would impede the implementation of the policy Congress has adopted in Section 63a(7). It would as well hamper the prompt liquidation of contingent or uncertain claims, for which Congress has provided in Section 57(d).

Considerations of essential fairness, moreover, require that petitioner not have a first preference. The result would be to exclude the general creditors and those having subordinate priorities. This would be

contrary to the Congressional purpose of restricting priorities and maximizing the fund available to general creditors. In addition, it was petitioner and the similarly situated claimants who were better able to insure against their fire loss, and upon whom the loss should therefore rest.

II

Congress has expressly provided that the rules governing equity receiverships, on which petitioner relies, should be utilized in reorganizations under Section 77 and Chapter X of the Bankruptcy Act. The statute provides, in contrast, that the rather different rules of ordinary bankruptcy should apply to arrangements under Chapter XI. Moreover, in reorganizations the existence of the original corporate entity terminates, so that there is a need to make provisions for payment of all claims against the original entity, including those based on torts committed during the reorganization period. There is, accordingly, no basis for applying the "equity" rules in cases under Chapter XI.

But even were the equity rules to be applied petitioner's claim should be subordinated to that of the United States, since such rules do not automatically treat tort claims as first priority expenses.

ARGUMENT

INTRODUCTION

This case, as does any growing from a debtor's bankruptcy, revolves about the creditor's forced participation in a game of musical chairs. By definition someone will lose; the essential issue is which of the competing parties has the priority that will allow its

claim to be satisfied first from a fund inadequate to pay all.

In such cases there are three general aims: to conserve the debtor's estate, to administer it in an orderly fashion, and to do such equity as is possible in distributing the remains to the claimants. Because these objectives are more easily stated than implemented, Congress has adopted a comprehensive Bankruptcy Act, which defines the claims that may be presented and the order in which they should be satisfied. Those statutory provisions must of course control this case.

Because the proceeding here is an ordinary liquidating bankruptcy, the priorities are determined by Section 64a of the Bankruptcy Act. The United States' unsecured tax claims undisputedly have a fourth priority that places them behind administrative expenses, Section 64a(1), and workmen's claims, Section 64a(2), but ahead of the claims of general unsecured creditors. The claims of petitioner and the others to whose premises the Fretz Building fire spread come ahead of the tax claims only if they properly constitute administrative expenses. Otherwise, such claimants either must share with the general creditors who have no priority, or seek satisfaction outside the bankruptcy court.

Section 64a(1) gives the first priority to "the costs and expenses of administration * * *." The same subsection provides that where an ordinary bankruptcy follows upon another proceeding under the Bankruptcy Act, such as the Chapter XI arrangement here, the "unpaid costs and expenses of administration" of the earlier proceeding are to share in the first priority, although subordinately to the administrative expenses

of the bankruptcy. Chapter XI has no express definition of the "costs and expenses of administration" of an arrangement. It adopts by reference, however, "the statutory provisions" applicable in ordinary bankruptcy "insofar as they are not inconsistent with or in conflict with the provisions of" Chapter XI: Section 302, 11 U.S.C. 702. It is settled that the effect of this language is to measure claimed administrative expenses of the arrangement by the standards applied in an ordinary bankruptcy. *E.g., American A. & B. Coal Corp.* v. *Leonardo Arrivabene, S.A.*, 280 F. 2d 119, 124 (C.A. 2).

The court's authority to allow payment of the administrative expenses of a bankruptcy is conferred by Section 62a(1) of the Act: "The actual and necessary costs and expenses incurred by officers, other than referees, in the administration of estates" may be paid if they "be reported in detail under oath, and examined and approved * * * by the court." In granting such expenses a first priority, Section 64(1) lists several that should be included. The first such category comprehends "the actual and necessary costs and expenses of preserving the estate subsequent to filing of the petition * * *."

The phrase "actual and necessary"—included in both Section 62a(1) and Section 64a(1)—must be the beginning point of the analysis of this case. Because the dividing line between the includable and the excludable is not clear, the solution must be sought in the several policies underlying the Bankruptcy Act and its priority provisions.

Petitioner essentially relies upon the cases that have allowed tort claims to be paid as administration expenses in reorganizations under Chapter X and Section 77 of the Bankruptcy Act, as well as in equity receiverships. But, contrary to petitioner's thesis, these authorities do not automatically grant such claims the first priority of expenses of administration. Indeed, it is taxes that have the top priority in ~~Chapter X proceedings~~ reorganizations—by reason of Section 199 of the Act, which does not apply in ordinary bankruptcies and Chapter XI arrangements.

There is a further, and more fundamental, defect in petitioner's position. Although Congress has with some statutory modification adopted rules developed in the administration of equity receiverships for use in proceedings under Chapter X and Section 77, it has at the same time adopted a rather different set of rules—set forth mainly in Sections 62a(1) and 64a(1)—for the administration of ordinary bankruptcies, arrangements under Chapter XI, and proceedings under Chapters XII and XIII of the Bankruptcy Act.

For these reasons, the rules governing receiverships are not applicable to the problems posed in this case. Rather the fashioning of the proper rule here ultimately requires analysis of two questions relating to the policies that Congress has applied to ordinary bankruptcies: What are the objectives Congress sought to achieve in using the word "necessary" in defining in Section 62a the administration expenses of arrangements and bankruptcies that receive a first priority under Section 64a? and how would the first

priority petitioner claims square with the general place that Congress intended tort claims to have in ordinary bankruptcies?

I. THE CLAIMS OF PETITIONER AND OTHERS DAMAGED THROUGH THE SPREAD OF THE FIRE ARE NOT ENTITLED TO THE PRIORITY ACCORDED COSTS AND EXPENSES OF ADMINISTRATION OF AN ARRANGEMENT UNDER CHAPTER XI OF THE BANKRUPTCY ACT IN AN ENSUING BANKRUPTCY

A. THE WORD "NECESSARY" IN SECTIONS 62a(1) AND 64a(1) SHOULD BE APPLIED IN A MANNER THAT IMPLEMENTS THE CONGRESSIONAL PURPOSE OF LIMITING CLAIMS GIVEN PRIORITY IN ORDER TO PROMOTE THE RELIEF OF GENERAL UNSECURED CREDITORS AND OF CREDITORS HAVING SUBORDINATE PRIORITIES

The history of the present Bankruptcy Act, which dates to 1898, shows that Congress has on several occasions changed the priority provisions of Section 64a. In each significant instance the result has been to limit, and not to expand, the category of claims accorded priority; the continuing purpose has been to enlarge the fund available to creditors having a subordinate priority or no priority at all.

For example, in 1926, tax claims were demoted from first to essentially fourth priority, and the priority given real estate taxes was limited. See Section 15 of the Act of May 27, 1926, Ch. 406, 44 Stat. 662. The reason was that the prior statute had left "little or nothing in the estate for general creditors and subordinate priority claimants." 3 *Collier on Bankruptcy,* par. 64.402, at p. 2156. Then, in 1938, Congress eliminated the statutory provision that accepted in bankruptcy such priorities as State statutes created. The purpose

was to eliminate the multitude of additional priorities that States had given a variety of claims, including those sounding in tort,[5] with the consequent *de facto* exclusion of general creditors. See Analysis of H.R. 12889, 74th Cong., 2d Sess., p. 201; 3 *Collier, supra,* par. 64.01, p. 2054, n. 27. See also *Groggin* v. *California* Labor Div., 336 U.S. 118, 127–129, n. 8; 3 *Collier, supra,* par. 64.501. Most recently, in 1966, the fourth priority given pre-bankruptcy tax claims was limited to amounts that have accrued within three years preceding the bankruptcy; experience had shown that unknown claims for past taxes were often so unpredictably large that "little or nothing was left for distribution to general creditors who provided goods and services to the bankrupt" (H. Rep. No. 687, 89th Cong., 1st Sess., pp. 3–4). See Sections 2 and 3 of P.L. 89–496, 80 Stat. 270; 3 *Collier, supra,* par. 64.01, pp. 2058–2061.

Congress has not dealt in such specificity with the administrative expenses given the first priority as it did in these amendments. Yet it is clear that Congress, in using the word "necessary," has sought to impose a significant limitation on the nature of the expenditures that may receive the first priority.

The history of national bankruptcy legislation is marked by many changes resulting from continuing controversies over which creditors shall be paid, and in which order. But one of the most constant features

[5] In at least eleven States, statutes had given tort claims varying degrees of preference. See *e.g.*, *Rial* v. *Chatman*, 70 F. 2d 21 (C.A. 4); Underhay, Tort Claims in Receivership and Reorganization, 22 Iowa L. Rev. 60, 81 (1936).

286-711--68——3

has been the limitation of allowable administrative expenses to "necessary" ones.

The word has been in every bankruptcy act since that of 1841. The short-lived [6] act of that year directed the district courts to promulgate rules "to avoid all unnecessary expenses" in the administration of bankrupt estates. See Section 6 of the Act of August 19, 1841, Ch. IX, 5 Stat. 440. The next national bankruptcy act was adopted in 1867. For the full 11 years of its existence [7] it provided that the assignee—*i.e.*, the trustee—"shall be allowed, and may retain out of money in his hands, all the necessary disbursements made by him in the discharge of his duty * * * ." Section 17 of the Act of March 2, 1867, Ch. CLXXVI, 14 Stat. 517. Sections 62 and 64 of the modern Act, first adopted in 1898, have always referred to the "actual and necessary" expenses of administration.[8] See Section 62 and 64 of the Act of July 1, 1898, 30 Stat. 544, 562, 563.

The courts must determine what are the "necessary" expenses of administration of each bankruptcy and arrangement. An essential guide is the reference in Section 64a(1) to "preserving the estate subsequent

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[6] The Act of 1841 was repealed by the Act of March 3, 1843, Ch. LXXII, 5 Stat. 614.

[7] The Act of 1867 was repealed by the Act of June 7, 1878, Ch. 160, 20 Stat. 99.

[8] The draftsman of the original bill that later became the Bankruptcy Act of 1898, c. 541, 30 Stat. 544 stated, (S. Doc. No. 156, 55th Cong. 2d Sess., p. 11) "The * * * expenses [other than the compensation fixed for referees and trustees] will be only such as are actual and necessary; they will not be paid until they have been reported in detail under oath and allowed by the court."

to filing the petition." Thus the focal point has been the determination of the nature and degree of the benefit a particular expense confers on a particular insolvent estate.

One of the earliest cases stating this general rule is *Randolph* v. *Scruggs,* 190 U.S. 533. At issue was the allowability and priority status in bankruptcy of fees for services attorneys had rendered to the insolvent estate during a prior assignment for the benefit of creditors— a procedure analagous to the arrangement at issue here. Mr. Justice Holmes, speaking for an unanimous Court, held that fees for advice given the assignee could be included in the assignee's expenses of administering the estate, which then as now had a first priority. But not all such fees were to be allowed. "We are not prepared," the Court stated, "to go further than to allow compensation for services which were beneficial to the estate." 190 U.S. at 539.

This same approach has resulted in a continuing judicial attempt to recognize (*In Re Connecticut Motor Lines, Inc.* 336 F. 2d 96, 100 (C.A. 3)):

> a cleavage between allowing as first priority matters * * * [expenses] arising from post-bankruptcy activities geared towards development or preservation of the bankrupt's assets, but disallowing as an expense of administration, * * * [those] attaching to post-bankruptcy activities incidental to the development or preservation of the bankrupt's assets. * * *

Thus in *Connecticut Motor Lines,* the Third Circuit refused to give a first priority to taxes withheld from

wages paid upon the windup of a bankruptcy, because the wages related to services rendered before the bankruptcy was adjudicated. First priority also has been denied a use tax levied after adjudication on an incompleted ship built before bankruptcy, notwithstanding the availability of the vessel as an asset of the estate. *In Re Mt. Washington S.S. Co.*, 43 F. Supp. 176 (D.N.H.)

The usual dispute over the administrative expenses of an ordinary bankruptcy goes to such items as the alleged excessiveness of a legal fee charged the trustee, or the allowability within the first priority of items, such as taxes, that grow out of transactions antedating bankruptcy but become payable thereafter. However, the problem is somewhat different when, as in a Chapter XI proceeding, a receiver, trustee or debtor continues to operate an insolvent business. In these circumstances the category of administrative expenses is enlarged to include at least some expenses that are "necessary" in the sense that without the goods or services which they represent the business would be unable to operate. Thus the courts have included within administrative expenses amounts owed suppliers, employees, landlords, and other who deal with the estate after the filing of the petition. *White* v. *Murtha*, 343 F. 2d 831 (C.A. 5); *In Re Capital Service*, 136 F. Supp. 430 (S.D. Calif.); *In Re Irving Electrical Supply Co.*, 41 F. Supp. 16 (S.D.N.Y.). Similarly, taxes arising from transactions entered into during the arrangement are given the priority of administrative expenses, since the business continues to have the use and protection of govern-

mental services and facilities. See 3 *Collier, supra,* par. 62.14[3]; *Swarts* v. *Hammer,* 194 U.S. 441; see, also, *Nicholas* v. *United States,* 384 U.S. 678, 691–693.

By such a priority, people are encouraged to work for or sell to a business that—without such priority—would be unable to pay them, and governments are encouraged to allow the business to continue. As a result, the priority enhances the possibility of rehabilitating the debtor, a particularly important objective in a Chapter XI proceeding. Cf. *Securities & Exchange Commission* v. *U.S. Realty Co.,* 310 U.S. 434; *Nicholas* v. *United States,* 384 U.S. 678, 684–685, 687; H. Rep. No. 2320, 82d Cong., 2d Sess., pp. 9–10; S. Rep. No. 1954, 87th Cong., 2d Sess., pp. 5–6.

But not every expense of operation acquires the first priority. For example, in *Denton & Anderson Co.* v. *Induction Heating Corp.,* 178 F. 2d 841, the Second Circuit refused to include within administrative expenses sales commissions on orders that had been secured before, but not filled until after, the filing of the Chapter XI petition. As that case demonstrates, the word "necessary" is given a relatively narrow construction—to include within the first priority only such operating expenses as are essential to assure that the insolvency existing on the date the arrangement begins has as neutral as possible an influence on the ability of the business to operate thereafter.

Thus, we submit, the essential question here is whether allowance of petitioner's tort claims as an administrative expense is necessary to allow the continuation, and thereby the rehabilitation, of such insol-

vent businesses as that of I. J. Knight Realty Corporation.

B. THE POLICIES THAT ALLOW A FIRST PRIORITY TO CERTAIN OPERATING EXPENSES OF CHAPTER XI ARRANGEMENTS DO NOT JUSTIFY GIVING THE SAME TREATMENT TO PETITIONER'S TORT CLAIMS

Without the first priority of administrative expenses, workmen, suppliers, and others who are asked to deal with the business during the arrangement would not have a realistic hope of full payment; they would be unlikely to deal with the debtor and the arrangement could not proceed. Through the priority, the debtor can deal with such people upon a slate relatively unmarred by the pre-existing insolvency.

This is the reason for granting the first priority, and it is a policy with a limited purpose. We submit there is no justification for giving its application a scope which exceeds its essential function. Its entire thrust is to induce volitional dealings with a business that would otherwise be terminated because of its insolvency. To exclude from the priority tort claims such as the one involved here is not, as the dissenters below suggested (R. 59), to say that "contractual claims are unjustifiably exalted" over those sounding in tort. Rather, it is to recognize that the Fretz Building fire and its spread in no manner involved volitional acts on the part of petitioner and the similarly situated claimants.

These claimants all necessarily acted in the same manner as they would have if the Knight Company had remained solvent or had been adjudicated a bankrupt before the fire—and in the latter instance

Section 63a(7) of the Act, which limits the provability of claims founded upon negligence to those that are the subject of a court suit filed before bankruptcy (see pp. 20–26, *infra*), would have barred the assertion of their claims in the bankruptcy proceeding. In addition, whether or not there had been an arrangement, the building would have remained in existence, the sprinkler system would have presumably required repair, and petitioner's property would have remained nearby. It thus cannot even be said that the continuation of the business in some manner made the risks of damage to such persons as petitioner greater than those that would have been incurred in the absence of the arrangement. Therefore, the reasons that allow a first priority status to various operating expenses in no way apply to whatever damages resulted from this particular fire.

This analysis does not require the conclusion that a tort resulting from the negligent operation of a business during an arrangement may never be a "necessary" cost of the administration. It is to say only that each case must be analyzed in its own context, and be decided according to the nature and degree of relationship between the operation of the business during the arrangement and the tort. For example, an injury to a member of the public—a business invitee—who was injured while on the business premises during an arrangement would present a completely different problem. The activity—the opening of a store to would-be customers or an office to a potential supplier—would be an integral and

essential element of the continuation of the business, and any hopes it may have of rehabilitation. The invitee has through a voluntary act entered upon the premises with a view to dealing with the debtor. To be sure, the entry on the premises would not have been made with the expectation of injury, or with any reliance on the prospect of claims for an injury receiving a first priority. On the other hand, such an injury could not occur in the absence of the arrangement—since without it the business would not have continued to operate—so that it may cogently be argued in such a case that the reasons that have led to the grant of priority to the contractual claims of employees and suppliers should equally apply.[9]

Nor would denial of the first priority to petitioner mean, as the dissenters below argued (R. 59), that "the risks to which the public is exposed by torts which experience shows are an inevitable result of the operation of a business are treated as outcast." The necessary premise for this assertion is the theory that petitioner and other tort victims would have no recourse except as a claimant within the first priority. But there is no support for this view in either the statute or the cases. The only support is petitioner's own disclaimer (Br. 19), which the referee and district court accepted (R. 25, 33, 44, 45; see also R. 59) of the ability to share in the estate as a general unsecured creditor.

[9] Comparable arguments could be advanced in support of a variety of tort claims—for example, one based on injuries inflicted during an arrangement by the negligent operation of a delivery truck is arguably entitled to priority on the theory that the truck would not have been operating in the absence of the arrangement.

Petitioner did not file a timely claim as a general unsecured creditor, and did not file suit in the time Section 63a(7) requires; it is now barred from recovery in this bankruptcy proceeding unless it obtains a first priority. See *In re Connecticut Motor Lines, Inc., supra,* at p. 108; *Denton & Anderson Co.* v. *Induction Heating Corp., supra,* at pp. 843–844. But if petitioner had filed such proof and suit, there would be no basis for excluding its claim.[10]

Because such a claim may share in the general fund, there is no need to grant a first priority to avoid the result which the dissenters below predicted and we agree should be avoided—the failure of trustees to secure public liability insurance. A trustee's principal obligation is to the general creditors. His duty is to maximize their shares in the estate. The

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[10] The only reason for finding that if petitioner filed suit before bankruptcy, it would not qualify for a share as a general creditor is Section 378(2) of the Bankruptcy Act, which provides that when bankruptcy follows an arrangement, the bankruptcy "proceeding shall be conducted, *so far as possible*, in the same manner and with like effect as if a voluntary petition * * * had been filed and * * * adjudication * * * entered on the day when the petition [for the arrangement] * * * was filed * * *." (Emphasis supplied.) Nothing in the statute would bar a holding that it is not "possible" to give effect to the earlier date, if such effect would disallow a claim for a tort committed during the arrangement and resulting in the filing of a suit before the bankruptcy. On the contrary, *Nicholas* v. *United States*, 384 U.S. 678, 685 n. 13, suggests that Section 378(2) would not be interpreted in a manner that would treat petitioner's claim as though it had arisen after the arrangement turned into a bankruptcy, and thereby, see, *e.g.*, *Favelo* v. *Reeves*, 227 U.S. 625, 631, bar it from proof in the bankruptcy proceeding altogether. But see *Valdes* v. *Feliciano*, 267 F. 2d 91 (C.A. 1).

prospect of tort claims being charged against the general fund is no less a deterrent upon the trustee than would be a grant of first priority. And if petitioner could not have claimed the status of general creditor, the result would be that the tort claim would not be discharged, so that the trustee's fiduciary duty to the debtor should result in his carrying the requisite insurance.

C. THE GRANT OF A FIRST PRIORITY TO TORT CLAIMS WOULD CONFLICT WITH THE GENERAL TREATMENT OF SUCH CLAIMS IN BANKRUPTCY

Claims for damages resulting from torts have traditionally been disfavored in bankruptcy. The precise reason is shrouded in antiquity. This Court has suggested that the original reason was that "Historically, bankruptcy laws, both in England and in this country, have dealt primarily and particularly with the concerns of traders." *Schall* v. *Camors,* 251 U.S. 239, 250. Thus, in *Schall* v. *Camors,* this Court held that a tort claim resulting from the bankrupt's fraud was not provable in bankruptcy.

Whatever may have been the original purpose of excluding claims founded in tort from being proved—and from being discharged—in bankruptcy, Congress in 1934 reviewed the question, and decided to allow a single limited exception. It added to the claims which Section 63 makes provable what is now Section 63a (7) (See Act of June 7, 1934, 48 Stat. 911, Section 4(a)):

> Debts of the bankrupt may be proved and allowed against his estate which are founded

> upon * * * (7) the right to recover damages in any action for negligence instituted prior to and pending at the time of the filing of the petition in bankruptcy; * * *

Under this provision only tort claims sounding in negligence may be proved and discharged in bankruptcy, and negligence claims qualify only if the claimant has instituted an action in court before a petition in bankruptcy has been filed. Although Congress did not expressly elucidate the reasons for these limitations, the policies underlying each are reasonably apparent.

The limitation to cases sounding in negligence excludes from bankruptcy claims arising from intentional torts. The rule thereby avoids a tortfeasor's using the procedures of bankruptcy to avoid the consequences of a purposeful wrong.

The requirement that suit be filed as a prelude to proving claims based on negligence, such as petitioner's, appears to have a distinct purpose—to complement and enhance the authority of the bankruptcy court to minimize delay in the distribution of a bankrupt estate by expediting the liquidation of contingent or uncertain claims. This policy is expressed in Section 57(d):

> * * * an unliquidated or contingent claim shall not be allowed unless liquidated or the amount thereof estimated in the manner and within the time directed by the court; and such claim shall not be allowed if the court shall determine that it is not capable of liquidation or of reasonable estimation or that such liquidation or estimation would unduly delay the administra-

tion of the estate or any proceeding under this title.

This proviso suggests that the rule limiting the provability of claims based on negligence reflects the impediment to the administration and distribution of the estate that inheres in the delay attendant upon proving the existence of negligence and the extent of resulting damages. See 3 *Collier on Bankruptcy, supra,* par. 57.15 at pp. 226–234, par. 63.25. Section 63a(7) ameliorates this potential for delay by requiring that judicial liquidation of the negligence claim at least be under way when the bankruptcy proceedings begin. At the same time, this procedure provides the bankruptcy court with significant flexibility in determining the manner in which the tort claim is to be liquidated, for the court has the option of allowing the negligence action to proceed where it was instituted, or instead enjoining the negligence action and having it tried and determined in the bankruptcy court. Compare *Matter of Baldwin,* 291 U.S. 610, 615; *Matter of United Button Co.,* 140 Fed. 495, 498 (D. Del.), affirmed, 149 Fed. 48 (C.A. 3).

To grant petitioner a first priority would contravene these policies. Congress plainly intended that claims based on negligence have no greater status than those of general unsecured creditors. The fact that the Fretz Building fire occurred during a Chapter XI arrangement is merely fortuitous, and provides no justification for promoting petitioner's claim to the first priority in a manner directly contrary to the provisions of Sections 63a(7) and 57(d). Petitioner advances no reason why it should be relieved

of the responsibility of filing a suit before the adjudication in bankruptcy. Nor is there any reason why petitioner should be allowed to avoid the authority Section 57(d) gives the bankruptcy court to control the liquidation of the negligence claim in the manner best suited to expeditious administration of the bankrupt estate.

The allegations underlying this case indeed demonstrate the intended interaction of Sections 63a(7) and 57(d), and the manner in which a grant of first priority would frustrate that interplay. A bankruptcy court might well conclude that the issues of negligence and proximate cause might better be resolved in a state trial court. But petitioner's approach deprives the court of this option.

An even more obvious example relates to the items of loss and expense that petitioner included in its itemized claim of damages (R. 13–16). Various types of railroad equipment are alleged to have been damaged in amounts ranging from $187 to $164,000. An extensive array of railroad operations is claimed to have been needed to clear the grades and make repairs. Additional expenses of $60,000 for unloading cars and chartering buses are said to have resulted from the inability to use certain facilities (R. 15–16). There is a claim of a loss of $39,000 in revenue over a ten-day period (R. 16).

A trial of extensive proportions, going into numerous details of the railroad business and the Reading Company's own operations, is essential to evaluate these specific claims of damages. No one can tell from the present record how long such an evaluation will

take, and what is the most expeditious manner of resolving the matter. Perhaps it can all readily be resolved by stipulations before the referee. On the other hand, the court's best judgment might be that a jury decision, based on expert testimony, would be the better approach. But whatever the bankruptcy court might decide, Section 57(d) contemplates that the court should have the utmost flexibility in directing the manner of liquidation. Section 63a(7) complements this authority by making available to the bankruptcy court a relatively prompt decision by a traditional trial, if this is deemed to be the best approach. Yet, the necessary result of allowing the procedure which petitioner seeks is completely to tie the hands of the bankruptcy court and its referee. If petitioner's claim is made an administrative item, the estate cannot be wound up until the amount of the claim is liquidated. If petitioner is not bound by the procedure established in Section 63a(7), the bankruptcy court is, as a practical matter, deprived of the flexibility that Congress, in Section 57(d), has provided to expedite resolution of unliquidated claims and avoid delay.

We think it notable that no one's research has disclosed a single case in bankruptcy or under Chapter XI that allows proof of any tort claim except as Section 63a(7) directs. Petitioner is wrong in saying that *Vass* v. *Conron Bros.*, 59 F. 2d 969 (C.A. 2), or *In re Progress Lektro Shave Corp.*, 35 F. Supp. 915 (D. Conn.) are such cases.

Vass involved a State court suit by a lessee of a cold storage plant for damages to the lessee's goods

resulting from the bankrupt lessor's failure to refrigerate the building. Although the suit contained an alternative count based on negligence, Judge Learned Hand found "this adds nothing." 59 F. 2d at 970. In ruling that the lessee's damages could be liquidated only in bankruptcy, and not in a State action, the court expressly relied on the trustee's "making himself liable on the covenants" of the lease. *Id.* at 971.

In re Progress Lektro Shave Corp. was a patent infringement suit, based on the trustee's public sale of shavers and parts subject to the claimant's patent. This case is therefore no different from others that allow a claim where the failure to do so would result in unjust enrichment of the bankrupt estate. *Cf. American A. & B. Coal Corp.* v. *Leonardo Arrivabene S.A.*, 280 F. 2d 119, 125–126 (C.A. 2); 3 *Collier on Bankruptcy* (Fourteenth ed. 1964), Para. 63.25. And although elements of tort inhere in actions for infringement, it is a mixed matter that has many of the conceptual elements similar to suits on implied contracts resulting from the provision of goods and services.[11]

This, then, would be the first case in which a court would have allowed a tort claim in bankruptcy where the procedure of Section 63a(7) was not fol-

[11] The dissenters below asserted that a third case, *In re Michigan Motor Specialties Co.*, 288 Fed. 377 (E.D. Mich.), was a bankruptcy case giving a first priority to a tort claim (R. 59 & n. 7). But that case, like *Progress Lektro Shave*, is a patent infringement case; the principal issue was whether bankruptcy terminated an exclusive license between the patentee and the bankrupt.

lowed. In *Schall* v. *Camors, supra,* this Court explicitly anticipated cases such as *Vass* "[w]here the tortious act constitutes at the same time a breach of contract," and cases such as *In re Progress Lektro Shave* "where * * * the tort-feasor obtains something of value for which an equivalent price ought to be paid, even if the tort as such be forgiven, there may be a provable claim *quasi ex contractu.*" 251 U.S. at 251. As this Court recognized, such cases raise "a different question" than one such as the present suit involving "a mere tort * * *." Resolution of the "different question" here must be premised on the congressional policies of Sections 63a(7) and 57(d) of the Bankruptcy Act. Only the weightiest considerations should justify a departure from those policies. No such consideration exists in this case, and no such departure is appropriate.

D. THE PERTINENT EQUITABLE CONSIDERATIONS REQUIRE THAT PETITIONER BE DENIED A FIRST PRIORITY

Petitioner's entire argument is premised on its assertion (Brief, p. 8) that "equitable considerations" require a grant of first priority to the victims of the Fretz Building fire. Petitioner—apart from its unjustified reliance on and erroneous interpretation of rules growing from "equity" receiverships (see pp. 30–34, *infra*)—has advanced no such consideration, and those that we perceive militate towards enforcement of the policies of Sections 62a(1), 63(a)(7), 64a(1), and 57(d).[12]

[12] Petitioner's assertion (Brief, p. 7) "that the bankruptcy court is a court of equity" is based on an unjustified truncation of the statutory language, which provides, in section 2, that

Such injuries as petitioner may have experienced in no way resulted from its relying on the existence of the arrangement, or acting in any manner different than it would have in the absence of the arrangement. Nothing essential to the conduct of the business during the arrangement can fairly be said to have caused the fire. Petitioner is in no different position than any other victim of an insolvent or judgment-proof tortfeasor. Had the fire preceded the arrangement, tort claims in bankruptcy unarguably would be limited to those who filed suit, and they would be only general creditors. Had the fire occurred during bankruptcy, Section 63a(7) would necessarily bar petitioner's claim.

Petitioner's position thus has in reality one and only one premise—the fortuitous fact that the Fretz Building fire occurred during a Chapter XI arrangement is said to entitle it to the greater dividend of the first priority. Nothing in "equity" or the Bankruptcy Act justifies placing petitioner in any better position than any other tort victim whom Congress has required to file suit before the bankruptcy as a prelude to presenting a claim in bankruptcy as a general creditor.

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district courts, as courts of bankruptcy, "are hereby invested * * * with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in proceedings under this title * * *." We of course agree that the courts do and should seek to act equitably in filling the interstices of the Bankruptcy Act. But as this Court has repeatedly made clear, *e.g.*, *SEC* v. *U.S. Realty Co.*, 310 U.S. 434, 448, 455; *Williams* v. *U.S. Fidelity Co.*, 236 U.S. 549, 554–555, the congressional policies established in the Bankruptcy Act are the paramount consideration.

The cost of giving petitioner a first priority would be the total exclusion of creditors having a subordinate priority or no priority at all. For, if all negligence claims are proven in the fixed amount asserted, and granted the first priority, the tort claimants will receive approximately 20 cents on the dollar. No other claimant will receive anything. If, on the other hand, the tort claimants must share with, and had all proved their claims as general creditors, tort recoveries would have been reduced by at most a third—to 12 or 15 cents on the dollar. Wage claimants, the United States, and any others having subordinate priorities would be satisfied.

The general objectives of the Bankruptcy Act require the latter and not the former result. Congress has continually sought to limit priority claims to avoid exclusion of creditors having a subordinate priority or no priority (see pp. 10–11, *supra*). A prime objective of the Bankruptcy Act—the *equity* that it seeks—is to see that general creditors go away emptyhanded as seldom as possible. The result here, on the other hand, would be to exclude these creditors entirely. Wage claimants would also be entirely excluded. Granting petitioner a first priority would be inconsistent with the Congressional decision to grant subordinate priority status to the tax claims of the United States and the other governing bodies. These results would undoubtedly obtain wherever the priorities status of tort claimants was important enough to be litigated.

If considerations of essential fairness are to be the controlling element, we suggest that attention should

also be given to the problem of which persons can most fairly be expected to insure against losses such as petitioner experienced. It is unlikely that any property owner would seek, or any insurance company would grant, public liability insurance that would cover the combined losses asserted by those whose properties bordered on the Fretz Building and were consumed by a fire that spread in seldom experienced proportions. Insurance covering the spread of fire to adjoining premises is the exception and not the rule.[13] It is usual, however, for building owners to insure their premises against fire, and such insurance does not ordinarily depend upon whether the fire started on the insured's property or spread there from a neighbor's building. Therefore, it is those in the position of petitioner who could insure against these losses. The trustee, the debtor, or the creditors whom petitioner seeks to exclude could not reasonably be expected to obtain that insurance. To allow petitioner a first priority would, in such a circumstance, enlarge the loss of those who were unable to insure against it, while favoring those who could, and should, have mitigated their injury through obtaining what is the usual and ordinary fire insurance policy.[14]

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[13] For example, the standard fire insurance policy in force in Pennsylvania (See 40 Purdon's Pennsylvania Statutes Annotated (1966 Supp.), Sec. 636) provides insurance only for damage to the insured's property.

[14] Moreover, allowance of the first priority to petitioner's claim would contravene the reasonable expectations of statutory priority creditors. An arrangement may be proposed by general unsecured creditors; but it cannot be implemented without the

II. THE RULES OF "EQUITY" RECEIVERSHIPS DO NOT ENTITLE PETITIONER TO PREFERENCE OVER THE CLAIMS OF THE UNITED STATES

A. THE RULES APPLIED TO EQUITY, CHAPTER X, AND RAILROAD REORGANIZATIONS SHOULD NOT BE APPLIED IN ORDINARY BANKRUPTCIES AND ARRANGEMENTS.

Petitioner relies almost exclusively on cases and other authorities relating to equity receiverships or reorganizations of business corporations under Chapter X or railroads under Section 77 of the Bankruptcy Act. We do not dispute that tort claims arising during a receivership or reorganization period may be allowed in such cases, are not subject to the requirements of Section 63a(7), and have generally been given the priority status of general administrative expenses. But Congress has not made these rules part of the statutory scheme of ordinary bankruptcies and arrangements, and to adopt them would be inconsistent with the statuory scheme.

The Bankruptcy Act in its entirety provides a variety of procedures for the relief of insolvent debtors and the protection of their creditors. In gen-

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consent and forbearance of governments having tax claims and of statutory priority creditors. See Section 307 of the Act. That consent is premised on the predictability of the nature and extent of the administrative expenses that will be incurred and attain first priority during the arrangement. Were tort claims arising during administration given priority equal to the ordinary and expected commercial expenses of running the business during the arrangement, statutory priority creditors would be more likely to exercise their rights, Bankruptcy Act Sections 64a and 337(2), 11 U.S.C. 104(a) and 737, to insist that either they be paid in full before the arrangement proceeds or that the debtor be forced into bankruptcy.

eral, two distinct approaches have been used in defining administrative expenses and ordering the priority of claims in these various proceedings. One set of rules is those which have obtained in non-statutory equity receiverships. The other is those which Congress by statute created for use in ordinary bankrupticies.

Congress has expressly accepted many of the equity rules in Chapter X and Section 77. In contrast, Section 64a applies in ordinary bankruptcy, and Section 302 incorporates the rules of Section 64a for use in arrangements under Chapter XI. As the Second Circuit has reasoned in refusing to apply the equity rules in an arrangement (*In re Chicago Express, Inc.*, 332 F. 2d 276, 278):

> In § 77, relating to railroad reorganizations, subdivision (b) provides that "unsecured claims, which would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the day of the approval of the petition, shall be entitled to such priority and the holders of such claims shall be treated as a separate class or classes of creditors" * * *. In Chapter X, relating to corporate reorganizations, Congress in § 102 ruled out the application of § 64, and provided in § 115 that the court "shall have and may, in addition to the jurisdiction, powers, and duties hereinabove and elsewhere in this chapter conferred and imposed upon it, exercise all the powers, not inconsistent with the provisions of this chapter, which a court of the United States would have if it had appointed a receiver in equity of the

property of the debtor on the ground of insolvency or inability to meet its debts as they mature." In contrast, § 302 subjects priority questions in Chapter XI proceedings to the rules stated in § 64.

See also *In re Connecticut Motor Lines, Inc., supra; United States* v. *Anderson,* 334 F. 2d 111, 115–116 (C.A. 5); 3 *Collier on Bankruptcy,* par. 62.02, pp. 1396–1397; 6 *Collier on Bankruptcy,* par. 1.06, pp. 211–212, par. 3.17.

Furthermore, the recognition of tort claims in proceedings under Chapter X and Section 77 is not based solely on the statutory references to the rules of equity receiverships. Section 77 in fact gives tort claims a special statutory position in railroad reorganizations, because such claims so often arise in the ordinary course of operating a railroad. See Section 77(n) of the Act. There is in addition a need for recognizing tort claims arising during the administration of a reorganization that is not present in the ordinary bankruptcy or arrangement. By reorganization, the existence of one corporation is terminated; its assets and business are transmuted into a new corporate body. Some provision must be made for the new body's payment of all valid claims against the old. On the other hand, ordinary bankruptcy contemplates that the debtor will continue in existence and remain liable for whatever debts have not been discharged. If a Chapter XI arrangement is successful, the debtor of necessity continues in business and has become financially healthy and able to handle its obligations. And if the arrangement ends in bankruptcy, it is not different from any other bankruptcy.

Thus, the grant of a first priority through acceptance of petitioner's proferred authorities would be to apply the rules of equity receiverships to cases where Congress has provided otherwise, and where there is not present the basic factor that requires the making of some provision for every claim against estates to whose reorganization Congress has applied the "equity" rules.

B. EVEN THE RULES OF EQUITY RECEIVERSHIPS SHOULD NOT ENTITLE PETITIONER TO PRIORITY OVER THE TAX CLAIM OF THE UNITED STATES

Even if the rules of equity receiverships were to be applied here, to the exclusion of those governing bankruptcies, it would not follow that petitioner's claim must have the first priority claimed. In such receiverships the courts remain free to give tort and other claimants such priority as seems just and reasonable in the circumstances. For example, in *Piedmont Corp.* v. *Gainesville & N.W.R. Co.*, 30 F. 2d 525, 530 (N.D. Ga.), an equity receivership case, it was held that various court costs, expenses of sale, the compensation and expenses of officers of the court, including receivers and attorneys, and other necessary costs had priority over "[o]ther debts of the receivership * * * including tort liabilities," which, in turn, were given priority over a mortgage. See also *Underhay, supra*, p. 96.

The nature of the United States claim here, and the importance Congress has attached to it, favor preferring it over petitioner's claim, even if the "equity" rules were to be the basis of decision in this case. In reorganizations, see section 199, 271, and

77(e) of the Act, and arrangements, see sections 337(2) and 397, the United States has the right to insist on cash payment of its tax claims before the debtor secures relief under the Bankruptcy Act. Indeed the effect of Sections 77(e) and 199 is to give all claims of the United States priority in a reorganization over all claims of any other creditor. Thus a reorganization must provide cash payment in full to the United States, if the Government so insists. See *United States* v. *Anderson, supra,* at p. 116; 6A Colliers, *supra,* par. 9.10, at p. 215, par. 9.17, pp. 269–270.

To grant petitioner a priority ahead of the United States would ignore these qualifications that Congress has placed on the "equity" rules petitioner invokes. If its reliance on these authorities is to be accepted, the aspects of the rules governing reorganizations that favor the United States should also be applied in this case.[15]

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[15] There is no merit to petitioner's contention that denial of first priority status would violate the due process clause of the Fifth Amendment, and this would be true even if petitioner were correct in its claim that it could not have qualified as a general creditor. Not all claims in an insolvency situation can be satisfied in full. Congress in the bankruptcy statutes necessarily determined the provability and priority of claims against the estate in the light of all relevant public policy and equitable considerations. Nothing in the Constitution forbids the congressional decision to continue, with the limited exceptions provided in Section 63a, the traditional rule which forbids either payment or discharge of tort claims in bankruptcy. See *Kuehner* v. *Irving Trust Co.*, 299 U.S. 445; *Wright* v. *Union Central Ins. Co.*, 304 U.S. 502; cf. *Goldblatt* v. *Hempstead*, 369 U.S. 590.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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